

Aggressive tactics by activist hedge funds furrows brows

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As hedge funds multiply, their aggressive pursuit of market returns have propelled them into the very boardrooms of local companies.

The loosely regulated private investment funds use sophisticated financial tools and trading strategies such as short selling, or profiting from a bet that a company's performance will worsen, to produce above-market returns.

An increasingly popular strategy among hedge fund managers is to take a substantial stake in a company, generally five percent or more, and use their voting power to influence the company's management.

Called activist hedge funds, their growing clout is making some observers nervous.

Close to home

Locally, activist hedge funds have made waves in a number of companies.

Most recently, New York-based hedge fund Mason Capital Management LLC stepped up its battle with Wayne-based Internet Capital Group to elect a new board. Mason, which owned 1 percent of the company's equity and \$24.6 million in convertible bonds that represented potential ownership of 6.9 percent, recently informed the firm it that may seek

changes to the board via a proxy vote.

Such battles over corporate control can often be bitter and lengthy. In 2005, Wyomissing-based Sovereign Bancorp Inc. became locked in a heated battle over the company's direction with San Diego-based hedge fund Relational

Investors, which at the time owned about 8 percent of the company.

Sovereign responded to demands from Relational's founder and principal Ralph Whitworth by selling a large block of stock to Spain's Banco Santander Central Hispano, a "white squire" investor who was sympathetic to Sovereign management.

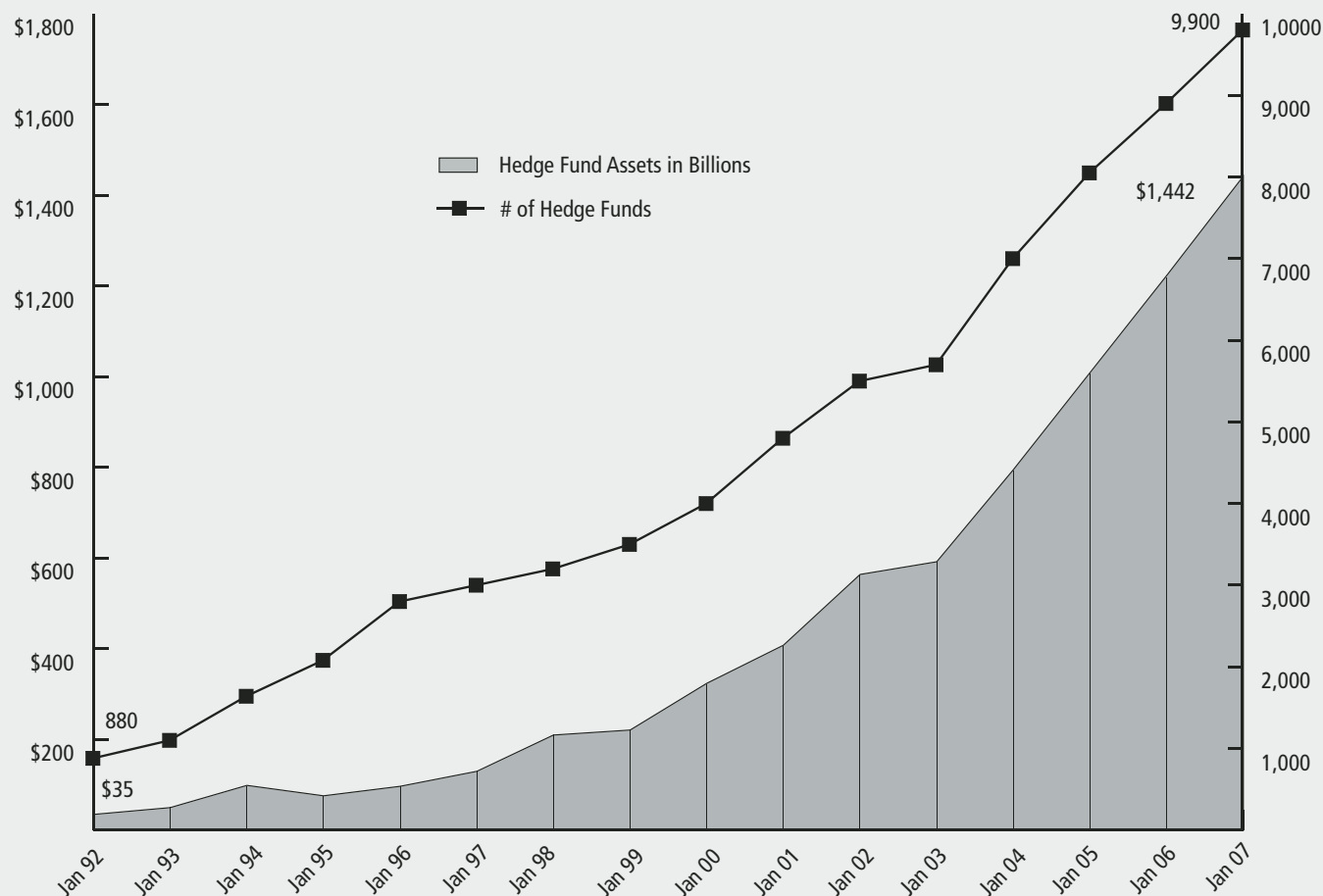
When the dust settled, Santander bought a 24.99 stake in Sovereign, Sovereign's then-CEO Jay Sidhu resigned, Whitworth won a seat on Sovereign's board and the bank announced a major restructuring plan in December. Since then, Sovereign's shares have risen nearly \$3.

In August of last year, Philadelphia-based Pep Boys-Manny, Moe & Jack came under pressure from Barington Capital Group, a New York-based hedge fund.

Barington, which owned approximately 5.85 percent of the auto shop company, demanded that it hire a new CEO, ap-

RISE OF THE HEDGE FUNDS

The first known hedge fund was launched by former Fortune writer Alfred W. Jones in 1949 and managed only \$100,000 in assets. Today, there are 9,900 hedge funds and at least 250 of them are each managing more than \$1 billion in assets.



Source: Hedge Fund Solutions LLC

'When an activist launches a campaign it can be very disrupting.'

Damien Park
Hedge Fund Solutions

point four new directors proposed by the fund group, reduce operating costs and re-evaluate its retail strategy. In the end, Pep Boys added four new directors and CEO Larry Stevenson was replaced in March by Jeffrey C. Rachor. Pep Boys stock recently hit a 52-week high of \$19.93 per share.

Money to burn

Shareholder activism by hedge funds has grown in part because of a booming growth in the industry itself.

The U.S. Treasury Department estimates that hedge funds control more than \$1.4 trillion in assets, an increase of more than 400 percent since 1999.

Christopher Geczy, finance professor at the University of Pennsylvania, puts that number at more like \$1.8 trillion. "Or maybe even over \$2 trillion," he said during a panel discussion on the hedge fund industry at the Wharton Economic Summit in Philadelphia last month.

The 2006 PerTrac Hedge Fund Database study, which tracks funds in a dozen major hedge fund databases, counted 19,775 distinct hedge fund-style groups, up 61 percent from 12,250 the year before. Approximately 250 of the funds manage more than \$1 billion in assets.

With so much capital pouring into such a rapidly growing industry, it is no surprise that more and more hedge funds are devoting time and money to activist causes.

"Shareholder activism by hedge funds

is rapidly becoming a discrete investment style," said Damien J. Park, president of Hedge Fund Solutions LLC, a Philadelphia-based firm that advises companies and hedge funds on how to work constructively with each other.

Park noted that many hedge funds are starting up funds specifically devoted to activist investing. He currently tracks 150 such funds in the United States — a number which he says grows every week.



Park

Growing concern

Critics argue that fund managers are only interested in quick profit, even if it results in expensive proxy battles for corporate control and decisions that ultimately harm the company.

"There's more moving than just the stock price. It's your employees, customers, suppliers and how you manage them," said Park. "When an activist launches a campaign it can be very disrupting to all those constituencies."

Such disruption comes at a cost. Park estimates that the average proxy contest costs \$1.5 million — in the form of fees to lawyers, consultants and public relations firms.

The danger of short-term hedge fund involvement was illustrated in a 2004 activist situation involving Canonsburg-based drug maker Mylan Laboratories and New York-based hedge fund Perry

Corp.

Knowing that Mylan shareholders would be voting on the potential acquisition of Bristol, Tenn.-based King Pharmaceuticals at the company's next shareholder meeting, Perry purchased 9.9 percent of Mylan's stock, hoping to influence the vote in favor of the acquisition. Since the fund owned 7 million shares of King's stock, it stood to make more than \$26 million from the sale.

What caught the attention of fellow shareholders was that Perry had also taken a short position on Mylan's stock, meaning that it wouldn't profit or lose from its purchase of the shares. Thus, Perry's only interest in buying the shares was seeing the acquisition go through — regardless of whether it was good for Mylan or its shareholders.

Eventually, the two companies terminated their agreement for the acquisition, but the whole episode alarmed industry observers, regulators and investors alike.

"Multiply Perry's behavior by the thousands of shareholder votes that occur every year at thousands of companies, and that's a lot of potentially lousy deals supported by major shareholders advancing narrow interests — and a lot of potential damage to the economy," wrote University of Pennsylvania corporate law professor David Skeel in an article on the subject in the November-December 2005 issue of Legal Affairs magazine.

HEDGE FUNDS: Betting that expensive proxy battles will improve shareholder return

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Fund industry digs in

Congress, the U.S. Treasury Department, Federal Reserve and the SEC have been considering whether to further regulate hedge funds.

"Many times these [hedge fund] investments are riskier and we would want to make sure that all of the risks of the investment are adequately disclosed to the investors," said Elaine Greenberg, associate regional director of the Philadelphia regional office of the SEC.

Industry insiders believe regulation would be misguided, even as some acknowledge it may be inevitable.

"Simply being activist is not on its face bad. For 70 years we've been trying to get shareholders to keep an eye on managers," said Edward Rock, corporate law professor and associate dean at the University of Pennsylvania law school.



Rock

Rock believes that the industry is best capable of regulating itself, notably via funds of hedge funds, which are funds that invest in hedge funds and thus are in a unique position to spot suspicious activities.

Others point out that regulators need to be clear on what kind of behavior they want to allow.

LOCAL ACTIVIST TARGETS

Internet Capital Group, Wayne

Date of activism: 2007

Activist Investor(s): Mason Capital Management
Ownership: 1 percent stock, plus \$24.6 million in bonds that could be converted to a stake of 6.9 percent.

Activist position: Mason informed ICG that they retained the services of a proxy solicitation firm in connection with their consideration of a proposal that may result in a change in the present board.

Outcome: None yet.

C&D Technologies Inc., Blue Bell

Date of activism: 2007

Activist investor(s): Sun Capital Partners
Ownership: 12.2 percent.

Activist position: Requested board representation.

Outcome: Sun Capital added one new director.

Pep Boys, Philadelphia

Date of activism: 2005/2006

Activist investor(s): Barington Capital, Pirate Capital

Ownership: 5.85 percent and 6.7 percent, respectively.

Activist position: Underperforming; explore

Source: Hedge Fund Solutions LLC. Ownership stakes were amount owned at time of action.

strategic alternatives for service center, evaluate real estate portfolio, reduce costs, re-evaluate retail strategy.

Outcome: CEO resignation; Barington added four new directors and Pirate added one new director.

Sovereign Bancorp Inc., Philadelphia

Date of activism: 2005/2006

Activist investor(s): Relational Investors
Ownership: 7.29 percent.

Activist position: Underperforming; request board representation.

Outcome: Sovereign employed "white squire" defense, CEO resigned, Relational added one new director; Sovereign announced a major restructuring plan in December.

SL Industries, Mount Laurel, N.J.

Date of activism: 2001/2002

Activist investor(s): Steel Partners, New Castle Partners

Ownership: 9.2 percent and 2 percent, respectively.

Activist position: RORID Committee — Responsible Owners Replacing Incumbent Directors; underperforming stock price.

Outcome: Activists obtain full board control.

"If it's within the law, then somebody's going to do it because there's money to

be made and if it's not a fair trading practice, then the answer is to change the le-

gality of the trading practice, not to regulate the hedge funds, because I don't see

what one has to do with the other," said Timothy Levin, a partner in the investment management practice at law firm Morgan Lewis & Bockius in Philadelphia.

Others argue that the Securities and Exchange Commission is doing plenty to monitor the market.

"Hedge funds and their managers are not unregulated," said Brian Vargo, a counsel in the financial services group of the law firm Dechert in Philadelphia and a founding member, officer and former director of the Mid-Atlantic Hedge Fund Association.

"In the past five years there have been in excess of 75 enforcement cases brought against hedge funds and hedge fund managers, including for misappropriation of assets, insider trading [and] misrepresentations of material information, like assets under management or portfolio performance," Vargo said.

At the Wharton Economic Summit, however, the panel of hedge fund managers seemed resigned to future regulation.

"I do think we'll all be registered and regulated to some degree in the next two or three years," said Craig W. Effron, managing partner of New York-based Scoggin Capital Management LP. ■



Levin